

**Improvements Are Needed to Ensure
Individual Taxpayers Have an Easy, No-Cost
Option to *e-file* Their Tax Returns**

August 2003

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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Corporate Programs)

SUBJECT: Final Audit Report - Improvements Are Needed to Ensure
Individual Taxpayers Have an Easy, No-Cost Option to *e-file*
Their Tax Returns (Audit # 200240083)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) implementation of the free electronic filing (*e-file*) initiative for individual tax returns.¹ The President's Fiscal Year 2003 budget included a proposal for an easy, no-cost option for taxpayers to file their tax returns online. The President noted that "today, individuals have to pay accountants, buy software, and pay fees just to file their tax returns. It should not be so hard to pay taxes."

In response, on October 30, 2002, the IRS entered into a 3-year Agreement² with a group of companies from the electronic tax preparation and filing industry³ to provide free *e-filing* to at least 60 percent of all taxpayers who file an individual tax return. This Agreement enabled the IRS to quickly offer certain taxpayers the option to *e-file* their tax returns at no cost using tax preparation software developed by industry experts, rather than having to try to develop its own tax preparation software. In addition, using established industry *e-file* capabilities would require little investment on the part of the IRS and would provide taxpayers with access to companies that have proven expertise and experience in the field of electronic tax preparation and *e-filing*.

¹ For the remainder of this report, we will refer to this initiative as the "Free File Program."

² For the purposes of this report, the term "Agreement" relates to the Agreement between the IRS and the Free File Alliance, LLC, not the Agreement between the companies involved in the Alliance.

³ This group has formed a limited liability corporation under the name "Free File Alliance, LLC," which is managed by the Council for the Electronic Revenue Communication Advancement.

Taxpayers can obtain information on how to participate in the IRS' Free File Program by accessing the IRS' Internet web site (www.irs.gov). The Free File web page provides a tool to assist taxpayers in determining whether they meet the eligibility requirements necessary to participate in the Free File Program. To determine eligibility, a taxpayer enters information that includes age, income, military status, and state of residence. Based on the information entered, a computer program determines if the taxpayer is eligible to participate and, if eligible, from which of the participating companies the taxpayer can select.

Despite time constraints and inexperience in developing and implementing this Program in time for the filing season,⁴ the IRS exceeded its Free-File Program goal of providing at least 60 percent of individual taxpayers with the option to prepare and *e-file* their tax returns at no cost. Specifically, the Free-File Program, implemented January 16, 2003, provided the no-cost option of tax preparation and *e-filing* to approximately 119 million of the estimated 127 million taxpayers who file an individual tax return.⁵

However, the terms of the Agreement result in a population of taxpayers who will incur a cost if they elect to *e-file* their tax return, because Agreement guidelines permit participating companies to change their eligibility requirements twice during a filing season and from year to year, or to discontinue participation in the Program at any time. The population of taxpayers not eligible to participate in the Free File Program included approximately 8 million taxpayers who, if they elected to *e-file*, would incur a cost. If, at any time, companies change their requirements and the total eligibility is reduced to the IRS' minimum goal of offering no-cost *e-filing* to 60 percent of all individual taxpayers, then nearly 51 million taxpayers would be ineligible to participate.

Time constraints contributed to the fact that procedures were not developed and implemented that could have reduced taxpayer confusion and difficulty. Specifically, taxpayers were not always provided with clear and accurate participation information, including the procedures to be followed to ensure taxpayers did not unknowingly receive a charge for *e-filing* and to ensure they receive immediate notification of company eligibility changes. In addition, the IRS has not developed a formal process by which to independently monitor and measure the success of the Program. The computer programming to add an indicator to identify those tax returns filed via the Free File Program could not be performed in time to enable the IRS to independently monitor the numbers and types of taxpayers participating during the 2003 Filing Season. Additionally, time constraints and not having the necessary technical expertise hindered the IRS' ability to independently monitor company compliance with key provisions in the Agreement, including privacy, security, and customer service.

To enable individual taxpayers to have an easy, no-cost option to *e-file*, we recommended that the Director, Electronic Tax Administration: 1) continue to work with

⁴ The filing season is the period from January through mid-April when most individual income tax returns are filed.

⁵ Eligibility requirements and the number of taxpayers eligible to participate in the Free File Program are subject to significant fluctuation. The reference to the number of eligible/ineligible taxpayers throughout this report is as of February 11, 2003.

the electronic tax preparation and filing industry to maximize the number of individual taxpayers who have the option to *e-file* at no cost, 2) continue to work with the tax preparation software industry to eliminate barriers affecting eligible taxpayers receiving no-cost *e-filing* and ensure taxpayers receive timely and accurate information, and 3) develop a formal monitoring process outlining the procedures for assessing the Program's success and company compliance with Agreement guidelines.

Management's Response: IRS management agreed with our recommendations and has initiated corrective actions. However, management did not agree that the only performance objective should be ensuring that all individual taxpayers are eligible to use the Free File Program. Instead, the IRS believes an equally important objective is to increase awareness of the Program, which will result in more Free File users.

While 119 million of the 127 million individual taxpayers were eligible to use Free File, IRS management stated that only 2.78 million did so. IRS management did not agree with the methodology and concept we used to determine our outcome measures that assume that 100 percent of all non-eligible taxpayers will use Free File if given the opportunity. In their view, this assumption, coupled with the low probability that 40 percent will not be eligible in the future, yields unreasonable expectations.

In addition, while the IRS acknowledged that the coverage of eligible taxpayers may fluctuate from year to year, the current Administration endorsed the requirement to maintain aggregate eligibility coverage of at least 60 percent of all individual taxpayers. Management's complete response to the draft report is included as Appendix VIII.

Office of Audit Comment: IRS management disagreed "that the only performance objective should be ensuring that all individual taxpayers were eligible to use Free File." We agree with management's assertion that this should not be the only performance objective, and in fact, we did not take that position in our draft report. Instead, we recommended that the IRS continue to work with the electronic tax preparation and filing industry to *maximize* the number of individuals eligible to *e-file* at no cost. In addition, management disagreed with our cost savings outcome measure with respect to the methodology and concept that 100 percent of all non-eligible taxpayers will use Free File if given the opportunity. As stated in our outcome calculation, the estimate is a *potential* cost savings, because we acknowledge the uncertainty of the number of taxpayers who, if provided the option to *e-file* at no cost, would elect to use this option in lieu of filing a paper tax return.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

**Improvements Are Needed to Ensure Individual Taxpayers
Have an Easy, No-Cost Option to e-file Their Tax Returns**

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Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to *e-file* Their Tax Returns

Background

The President's Fiscal Year 2003 budget included a proposal for an easy, no-cost option for taxpayers to file their tax returns online. The President noted that "today, individuals have to pay accountants, buy software, and pay fees just to file their tax returns. It should not be so hard to pay taxes." In addition, the Office of Management and Budget's Quicksilver Task Force¹ recommended "EZ Tax Filing," whereby the Internal Revenue Service (IRS) provided taxpayers free online tax return preparation and filing services; this electronic filing is known as *e-file*.

The IRS elected to use existing *e-file* industry expertise rather than develop its own free *e-file* system

In response to the President's budget proposal and the Quicksilver Task Force recommendation, on October 30, 2002, the IRS entered into a 3-year, public-private partnership Agreement with the Free File Alliance, LLC,² to provide no-cost tax preparation and filing to at least 60 percent of all taxpayers who file an individual tax return.³ Based on this level of coverage, the IRS expected a total of 2.4 million taxpayers to file their tax returns at no cost during the 2003 Filing Season.⁴

The IRS' decision to join with the electronic tax preparation and filing industry was based on a number of factors including a desire to quickly implement a Free File Program, the lack of immediate resources to develop a system to enable taxpayers to *e-file* their tax returns directly to the IRS, and the industry urging the IRS not to compete with it. Use of established industry *e-file* capabilities would require little investment on the part of the IRS and would

¹ This team was assembled from various Federal Government agencies to identify priority actions that would achieve strategic improvements in the Government based on citizen needs.

² Corporate name for a group of companies from the electronic tax preparation and filing industry that formed a limited liability corporation managed by the Council for the Electronic Revenue Communication Advancement.

³ For the purposes of this report, the term "Agreement" relates to the Agreement between the IRS and the Free File Alliance, LLC, not the Agreement between the companies involved in the Alliance.

⁴ The filing season is the period from January through mid-April when most individual income tax returns are filed.

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provide taxpayers with access to companies that have proven expertise and experience in the field of electronic tax preparation and *e-filing*.

In addition, the IRS already had a similar program in place under which companies from the electronic tax preparation and filing industry offered free *e-filing* to taxpayers who met certain requirements. For the past several years, certain companies had offered no-cost tax preparation and *e-filing* to select taxpayer groups through an IRS-sponsored web site. These services were offered mainly to assist low-income and underserved taxpayers.⁵ For example, during the 2002 Filing Season, 9 companies from the electronic tax preparation and filing industry offered both free tax preparation and *e-file* to approximately 58 percent of all individual taxpayers. Eligibility for an estimated 73 million individual taxpayers was generally based on the taxpayers having incomes of less than or equal to \$25,000. Approximately 1.2 million taxpayers took advantage of the offers during the 2002 Filing Season. These same companies are now part of the Free File Alliance, LLC.

The Free File Agreement specifies responsibilities for both the IRS and the participating companies

The Free File Agreement (formally referred to as the “Free On-Line Electronic Tax Filing Agreement”) includes specific responsibilities that both the IRS and the participating companies need to meet. Appendix V lists the key requirements that need to be met for companies to participate in the Program.

For example, the IRS agrees to host and manage the content of the Free File web page, refrain from endorsing any specific offerings or products, promote the free *e-file* services provided by the participating companies, and not offer an IRS brand of *e-file* during the term of the Agreement. The companies agree to establish eligibility requirements (see Appendix VI), disclose to users their

⁵ Those individuals that cannot reasonably access tax assistance by virtue of their income level, diversity, language, or age and for whom no reasonable alternative assistance is available in the commercial market.

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customer service support options and privacy policy,⁶ and work with taxpayers whose tax returns are rejected (i.e., not accepted for processing by the IRS because of an error).

The Free File web page is the gateway to participation in the Free File Program

Taxpayers can obtain information on how to participate in the Free File Program by accessing the IRS' Internet web site (www.irs.gov). The Free File web page provides a tool to assist taxpayers in determining whether they meet the eligibility requirements necessary to participate in the Free File Program. To determine eligibility, a taxpayer enters information that includes age, income, military status, and state of residence. Based on the information entered, a computer program determines if the taxpayer is eligible to participate and, if eligible, from which of the participating companies the taxpayer can select. Taxpayers are then provided with a link to the applicable companies.

Once taxpayers select the link for the company they choose, they leave the IRS' web site and enter the specific company's web site. These taxpayers will then be provided instructions on how to prepare and file their Federal income tax returns online using software provided by the participating companies. Upon completing their tax returns, taxpayers then have the option to *e-file* the returns to the IRS or to print and mail them to the IRS.

The audit was conducted from November 2002 through February 2003 at the IRS' National Headquarters in Washington, D.C., in the office of Electronic Tax Administration. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁶ 26 U.S.C. § 7216 (2003) prohibits the unauthorized use or disclosure of tax return information by tax return preparers.

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The Internal Revenue Service Exceeded Its Goal of Providing At Least 60 Percent Eligibility

Despite time constraints and inexperience in developing and implementing this Program in time for the filing season, the IRS' newest *e-file* initiative, the Free-File Program, exceeded its goal of providing at least 60 percent of individual taxpayers with the option to prepare and *e-file* their tax returns at no cost. Specifically, the Free File Program, implemented on January 16, 2003, for the 2003 Filing Season, provided the option of no-cost tax preparation and *e-filing* to approximately 119 million of the estimated 127 million taxpayers who file an individual tax return.⁷ The table below outlines the characteristics of taxpayers who were eligible to participate in the Free File Program as of February 2003. Taxpayers are required to meet one of the listed requirements to participate.

Free File Program Eligibility Requirements⁸

Eligibility Characteristics	Requirements to Qualify
Age	Less than 21 years old or at least 50 years old.
Income	Income \$50,000 or greater or \$33,000 or less.
Military Status	On active military duty.
Residence	Resident of Illinois, Georgia, North Carolina, Arizona, Michigan, Wisconsin, or Ohio.
Tax Credit	Qualify for the Earned Income Tax Credit.
Type of Tax Form	File using Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

Source: *Wage and Investment, Research Group I.*

⁷ Eligibility requirements and the number of taxpayers eligible to participate in the Free File Program are subject to significant fluctuation. The number of eligible taxpayers is as of February 11, 2003.

⁸ Taxpayers are required to meet only one requirement to qualify for participation in the Free File Program.

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However, to ensure individual taxpayers have an easy, no-cost option to *e-file* their tax returns, the IRS needs to address the following issues:

- The group of taxpayers eligible to participate was not consistent.
- Taxpayers were not always provided with timely and accurate participation information.
- The IRS was limited in its ability to independently monitor and measure the success of the Program.

The Group of Taxpayers Eligible to Participate Was Not Consistent

Maximizing and holding consistent the number of taxpayers who are eligible to participate in the Free File Program is essential to ensuring equitable taxpayer treatment and to reducing taxpayer burden, a key goal of the Program. Agreement guidelines permit participating companies to change their eligibility requirements twice during a filing season and from year to year, or to discontinue participation in the Program at any time.

The Agreement does not mandate which taxpayers will be covered, only that each participating company must offer free *e-file* to at least 10 percent of all individual taxpayers based on the eligibility requirements each company establishes. In the aggregate, companies participating must provide 60 percent of all individual taxpayers with the option to *e-file* at no cost.

As of February 2003, the population of taxpayers not eligible to participate in the Free File Program included approximately 8 million taxpayers. If these taxpayers elected to *e-file*, they would incur a cost. The following table provides some characteristics of the taxpayers ineligible to participate. Taxpayers ineligible to participate would meet all disqualifying characteristics.

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Characteristics of Taxpayers Who Are Ineligible to Participate in the Free File Program

Eligibility Characteristics	Not Qualifying
Age	Ages 21 to 50.
Income	Income over \$33,000 but less than \$50,000 (not filing a Form 1040EZ).
Military Status	Not in active military duty.
Residence	Do not reside in Illinois, Georgia, North Carolina, Arizona, Michigan, Wisconsin, or Ohio.
Tax Credit	Not eligible for the Earned Income Tax Credit.
Type of Tax Form	Not eligible to file Form 1040EZ.

Source: Wage and Investment, Research Group I.

Furthermore, if at any time company offerings are reduced to the IRS' minimum goal of offering no-cost *e-filing* to 60 percent of all individual taxpayers, then nearly 51 million taxpayers would be ineligible to participate. Inequitable treatment results as offerings do not cover taxpayers with the same or very similar characteristics. Specifically, some taxpayers will have the option to *e-file* at no cost, while others with the same or very similar characteristics will incur a cost to *e-file*, as shown by the following hypothetical examples:

Example #1

- *Taxpayer A - 20 years of age with an income less than or equal to \$33,000 or greater than \$50,000 is eligible to e-file at no cost.*
- *Taxpayer B - 20 years of age with an income between \$33,000 and \$50,000 is generally⁹ ineligible to participate.*

⁹ This taxpayer would, however, be eligible if he or she resides in one of the seven states covered by offers for free *e-filing*, is in active military service, or is filing a Form 1040EZ.

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Example #2

- *Company A - From January 16, 2003, to January 30, 2003, provided residents of New York State with the option to e-file at no cost.*
- *Company A - As of January 31, 2003, changed its eligibility requirements to rescind the offer of free e-filing to residents of New York State. Therefore, taxpayers with the same characteristics as those who filed between January 16 and January 30, 2003, will now incur a cost to e-file. The only difference is that these taxpayers did not e-file prior to January 31, 2003.*

The quickness with which the IRS developed and implemented its newest *e-file* initiative shows the IRS' commitment to expanding *e-file* opportunities for individual taxpayers. However, a recent IRS study¹⁰ found that taxpayers who prepare their tax returns using tax preparation software, but who elect to print and mail their tax returns to the IRS, often do so **because of the cost** they would have to incur to *e-file* their tax returns.

Under the present Agreement, at any time 40 percent of all individual taxpayers (approximately 51 million) are at risk of being excluded from participation in the Free File Program. If these taxpayers were to elect to *e-file*, they could incur a minimum cost of \$7.95¹¹ each, or an estimated \$403 million annually, just to *e-file* their tax returns. Also, if these taxpayers were provided with the option to *e-file* at no cost, and elected this option in lieu of filing a paper tax return, the IRS could save approximately \$37 million in processing costs yearly.¹²

¹⁰ Electronic Tax Administration - Survey of Taxpayers Who Use Paid Preparers and File V-Coded Returns Project 1-02-08-3-004 (1.51b) (dated October 2002).

¹¹ We used \$7.95 as a per tax return *e-file* cost to be conservative. This is the least expensive "for-pay" *e-file* service covering all individual tax returns (e.g., Forms 1040EZ, 1040A, and 1040) among the companies participating in the Free File Program.

¹² The IRS saves approximately \$1.08 per tax return to process an *e-filed* tax return instead of a paper tax return.

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Recommendation

To eliminate the costs taxpayers incur to *e-file* and ensure equitable treatment of taxpayers, the Director, Electronic Tax Administration, should:

1. Continue to work with the electronic tax preparation and filing industry to maximize the number of individual taxpayers who have the option to *e-file* at no cost.

Management's Response: Although the IRS agreed with this recommendation, the terms of the existing partnership Agreement with industry are to provide free services to at least 60 percent of taxpayers. The IRS accomplished and exceeded this goal. Even though the Agreement does not include a goal to provide free services to all individual taxpayers, the IRS will work with the industry to identify and implement ways to increase the percent of individuals eligible to use these free services.

However, IRS management did not agree that the only performance objective should be ensuring that all individual taxpayers are eligible to use the Free File Program. Instead, the IRS believes an equally important objective is to increase awareness of the Program, which will result in more Free File users.

While 119 million of the 127 million individual taxpayers were eligible to use Free File, only 2.78 million did so. IRS management did not agree with the methodology and concept we used to determine our outcome measures (see Appendix IV) that assume that 100 percent of all non-eligible taxpayers will use Free File if given the opportunity. In their view, this assumption, coupled with the low probability that 40 percent will not be eligible in the future, yields unreasonable expectations.

Office of Audit Comment: IRS management disagreed “that the only performance objective should be ensuring that all individual taxpayers were eligible to use Free File.” We agree with management’s assertion that this should not be the only performance objective, and in fact, we did not take that position in our draft report. Instead, we recommended that the IRS continue to work with the electronic tax

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Taxpayers Were Not Always Provided With Timely and Accurate Participation Information

preparation and filing industry to *maximize* the number of individuals eligible to *e-file* at no cost. In addition, management disagreed with our cost savings outcome measure with respect to the methodology and concept that 100 percent of all non-eligible taxpayers will use Free File if given the opportunity. As stated in our outcome calculation, the estimate is a *potential* cost savings because we acknowledge the uncertainty of the number of taxpayers who, if provided the option to *e-file* at no cost, would elect to use this option in lieu of filing a paper tax return.

Providing taxpayers with timely and accurate participation information is essential to ensuring the Free File Program goal – to make paying taxes easier for individual taxpayers – is fully achieved. Time constraints and not being familiar with implementing such a Program resulted in the IRS being unable to develop and implement procedures that could have reduced taxpayer confusion and difficulty. As a result:

- Taxpayers did not receive clear instructions as to the steps they need to follow for participation in the Program.
- Taxpayers were not immediately informed as to changes in company eligibility requirements or the impact the fluctuating eligibility requirements could have on them.

Taxpayers did not receive clear participation instructions

One key step needs to be followed by taxpayers who qualify to participate in the Free File Program to ensure they do not inadvertently receive a cost to *e-file* – taxpayers must access companies participating in the Free File Program through the IRS' web page. However, the IRS did not inform taxpayers of the need to access companies participating in the Free File Program via the IRS' web page. As a result, some taxpayers may have inadvertently had to pay to *e-file* if they began the process by directly entering a participating company's web site. The following example illustrates the confusion that taxpayers may have experienced:

- *Our auditor directly accessed one participating company's web site. Upon completing the tax return, the auditor was notified that, if he or she wanted to e-file*

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the tax return, a charge of \$7.95 would be incurred. The IRS Free File web page did not provide a caution that, to ensure no-cost e-file, taxpayers should use links provided on the Free File web page.

- *The auditor then went back and accessed the same company's web site, but this time went through the IRS' Free File web page; prepared the same tax return; and before e-filing, was informed that the tax return filing qualified for free e-file.*

Taxpayers were not immediately notified of company eligibility changes or the impact that these changes could have on them

As previously discussed, terms of the Free File Agreement allow companies to change eligibility requirements to be met by taxpayers to participate in the Free File Program. However, the IRS did not educate taxpayers to ensure they were aware that eligibility requirements can change and that the changes could affect the taxpayers' ability to participate at any particular time. Without this knowledge, there is the potential that taxpayers will reach erroneous conclusions regarding whether they can e-file at no cost. The following hypothetical example illustrates how this can occur:

- *A taxpayer with an income of \$33,000 determines that he or she earned more than the \$32,000 maximum income requirement for Free File participation posted on the Free File web page and pays to e-file. Later, this same taxpayer learns that the income threshold for Free File participation was increased to \$33,000 and, if he or she had waited, he or she could have e-filed at no cost.*

When these issues were brought to IRS management's attention during the audit, they immediately implemented interim procedures to ensure eligibility requirement changes were timely and consistently updated to the Free File web page. However, taxpayers did not receive cautionary information as to eligibility changes as well as how these changes could affect them. As a result, potential taxpayer burden can exist for any of the approximately 127 million individual taxpayers who may have attempted to determine if they were eligible to participate at any given time.

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Management noted that they continue to strive to ensure that timely and accurate information is available. However, regardless of the information provided to taxpayers via the Free File Program web page, the IRS will be continually challenged to ensure that taxpayers take the time and care to read the information being provided, in order to understand requirements for participation in the Program.

Recommendation

To reduce taxpayer burden, the Director, Electronic Tax Administration, should:

2. Continue to work with the tax preparation software industry to eliminate barriers affecting eligible taxpayers receiving no-cost *e-filing* and ensure taxpayers receive timely and accurate information.

Management's Response: The IRS agreed with this recommendation. For 2004, the IRS will continue to employ usability practices and work with industry members on improving the way it presents and displays important information to prospective Free File users.

Furthermore, to ensure the best experience possible and eliminate barriers, the IRS has successfully negotiated with the Free File Alliance to modify their operating agreement. This new Agreement will include provisions for the upfront disclosure of supported tax forms and schedules, state programs, and customer service options. These new requirements will help the taxpayer receive accurate and timely information.

The Ability to Independently Monitor and Measure the Success of the Program Was Limited

The Free File Agreement requires the IRS to develop an assessment process to measure the extent to which the Program is accomplishing its objectives. The objectives of the Program include making tax return preparation and filing easier, reducing the burden on individual taxpayers, and providing greater service and access to taxpayers.

The IRS, in an attempt to monitor the Program, has performed random checks to ensure participating companies were in compliance with various provisions in the Agreement. Time constraints resulted in the IRS being

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unable to implement a formal process to independently monitor and measure the success of the Program. For example, the computer programming necessary to add an indicator to identify those tax returns filed via the Free File Program could not be performed in time to enable the IRS to independently monitor the numbers and types of taxpayers participating during the 2003 Filing Season. The IRS, instead, had to rely on participating companies to provide this information.

In addition, time constraints and not having the necessary technical expertise hindered the IRS' ability to independently monitor company compliance with key provisions in the Agreement, including privacy, security, and customer service. The IRS relied in part on the assumption that the companies would police themselves and enforce the prohibitions imposed under Federal rules and regulations. Such prohibitions include the use of tax return data for purposes not specifically authorized by the taxpayer. Violation of these statutes can result in imprisonment of company officials.

Discussions with IRS management indicated that, as of March 12, 2003, the IRS was considering hiring a contractor to develop a process to enable it to perform appropriate oversight of company compliance with Agreement guidelines, while at the same time offering the maximum opportunity for effective partnerships with the private sector.

The inability of the IRS to independently monitor and measure the Program can result in taxpayer dissatisfaction with the Free File Program or inequities in the service provided by the various companies. Without effective Program oversight, the IRS is unable to ensure the success of the Free File Program in providing taxpayers with an easy and truly no-cost option to *e-file*. For example, our review of customer service options provided by companies participating in the Program showed that those taxpayers who have difficulty preparing and *e-filing* their tax returns could experience varied levels of customer service depending on the company they choose.

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The Free File Agreement requires companies to post their customer service options on their web sites but does not establish minimum standards for customer service. Some companies were charging as much as \$14.95 for telephone assistance, and others limited their customer service to frequently asked questions. One company was charging \$2.95 for re-filing a tax return that was rejected by the IRS because of an error. See Appendix VII for a summary of customer service options.

Recommendation

To enable independent monitoring of the Free File Program's success and company compliance with Agreement guidelines, the Director, Electronic Tax Administration, should:

3. Develop a formal process to monitor and measure the success of the Program, including company compliance with Agreement guidelines.

Management's Response: The IRS agreed with this recommendation. This year, the IRS will review each member's offerings prior to service being available to taxpayers. All Alliance member sites must be examined and approved before the IRS will post them on its Free File site. The IRS is developing a procedural handbook that it will use to perform and report on the examination of each web site. Additional monitoring of web sites will occur after the initial review and throughout the filing season to ensure that members make no unauthorized modifications.

The IRS will also develop a set of performance measures. These measures will be developed in cooperation with the Alliance members and will be evaluated against the Program's goals and objectives. This will ensure that the Program continues to grow and respond to taxpayer needs.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the Internal Revenue Service's (IRS) implementation of the free electronic filing (*e-file*) initiative for individual tax returns (referred to hereafter as the "Free File Program"). To accomplish this objective, we conducted the following tests:

- I. Obtained and reviewed provisions of the Free File Agreement between the IRS and a group of companies from the electronic tax preparation and filing industry and the separate Agreement that governs the group of companies offering *e-file* at no cost.
- II. Assessed the process the IRS followed that led to the Free File Agreement.
 - A. Interviewed IRS officials responsible for fulfilling the President's vision for a no-cost option for individual taxpayers to *e-file* their tax returns.
 - B. Identified any alternatives to the final Free File Agreement that were considered and determined/assessed the basis for the IRS' decision to enter into a partnership with the electronic tax preparation and filing industry.
 1. Researched various state free *e-file* initiatives.
 2. Interviewed officials from selected state tax agencies regarding state free *e-file* methods, experiences, and lessons learned.
- III. Determined whether the Free File Agreement results in equitable treatment of taxpayers.
 - A. Obtained a listing, as of February 11, 2003, detailing the Free File Program eligibility requirements.
 - B. Obtained a statistically valid sample of Tax Year 2000 tax return information from the Electronic Tax Administration Marketing Database.
 - C. Based on Tax Year 2000 tax return filing data, assessed the volume of taxpayers who will and will not be eligible to participate in the Free File Program.
 - D. Prepared an analysis to determine, based on taxpayer characteristics (e.g., prepare returns themselves or use paid preparers; prepare returns electronically but submit paper version to the IRS), whether the Free File Agreement results in no-cost *e-file* services being offered to the segment of taxpayers who will most benefit from the Agreement.
 - E. Determined if eligible taxpayers are likely to have access to the Internet that they need to participate in the Free File Program.

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- F. Obtained a Department of Commerce study that details by age, income, etc., the percentage of individuals who have home Internet access.
 - G. Stratified eligible taxpayers by income, age, etc., and assessed the percentage of these individuals who are likely or not likely to have home Internet access.
 - H. Evaluated IRS efforts to ensure Internet access for individual taxpayers.
- IV. Determined if controls are in place to ensure that any taxpayers who experience difficulty while using free *e-file* have effective customer support.
- A. Identified the options taxpayers have when experiencing problems while participating in the Free File Program.
 - B. Assessed the effectiveness of the IRS' process for communicating customer service matters to taxpayers.
 - C. Assessed whether sufficient customer service support resources are in place to ensure taxpayers who call the IRS for assistance are effectively assisted.

**Improvements Are Needed to Ensure Individual Taxpayers
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Appendix II

Major Contributors to This Report

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**Improvements Are Needed to Ensure Individual Taxpayers
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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:SE
Deputy Commissioner, Wage and Investment Division W
Director, Electronic Tax Administration W:ETA
Director, Strategy and Finance W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaison: GAO/TIGTA Liaison W:S:PA

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to *e-file* Their Tax Returns

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

Funds Put to Better Use – Potential; approximately \$37 million annually (see page 5).

Methodology Used to Measure the Reported Benefit:

Computation of the processing cost savings if the Internal Revenue Service (IRS) provides those taxpayers potentially excluded from the Free File Program with the option to *e-file* for free **and these taxpayers elect to use this option.**

- Total taxpayers = 126,601,522.¹
- Total taxpayers at risk of not being provided with an option to *e-file* at no cost if the number of eligible taxpayers only meets the IRS' goal of 60 percent, with 40 percent ineligible $(126,601,522 * 40\%) = 50,640,609$.
- Number of at-risk taxpayers who file paper tax returns $(68.14\% \text{ of } 50,640,609) = 34,506,511$. The percentage of individual taxpayers who file paper tax returns is based on an IRS Research function analysis of the Tax Year 2000 Electronic Tax Administration Marketing Database (used by the IRS for Free File Program estimates), which showed that 68.14 percent of all individual taxpayers filed paper tax returns for Tax Year 2000. The remaining taxpayers filed electronically.
- Cost savings per return if taxpayers who file paper returns elect to file via *e-file* = \$1.08.²
- Potential annual funds put to better use $(34,506,511 * \$1.08) = \$37,267,032$.

¹ Based on Tax Year 2000 Electronic Tax Administration Marketing Database which the IRS used for all estimates associated with implementation of the Free File Program (this is the number of taxpayers eligible to participate).

² The IRS saves approximately \$1.08 per tax return to process an *e-filed* tax return instead of a paper tax return.

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to e-file Their Tax Returns

Type and Value of Outcome Measure:

Reduction of Burden on Taxpayers –

- Potential; an estimated \$403 million in cost savings for individual taxpayers annually (see page 5).
- Potential; reduced difficulty and confusion for an estimated 126.6 million individual taxpayers (see page 9).

Methodology Used to Measure the Reported Benefit:

Potential; an estimated \$403 million in cost savings for individual taxpayers annually

Computation of the tax preparation and *e-file* costs that taxpayers could save if the IRS ensures that all taxpayers have the option to *e-file* for free.

- Total individual taxpayers = 126,601,522.
- Total taxpayers at risk of not being provided with an option to *e-file* at no cost if the number of eligible taxpayers only meets the IRS' goal of 60 percent, with 40 percent ineligible ($126,601,522 * 40\%$) = 50,640,609.
- Minimum cost for taxpayers to *e-file* their tax returns = \$7.95.³
- Total potential cost savings for taxpayers annually ($\$7.95 * 50,640,609$) = \$402,592,842.

Potential; reduced difficulty and confusion for an estimated 126.6 million individual taxpayers

Computation of the number of taxpayers who may experience reduced burden as a result of the IRS ensuring that taxpayers receive accurate and timely information regarding proper participation procedures and changes in eligibility requirements.

- Total number of individual taxpayers who file tax returns each year based on Tax Year 2000 tax return records maintained by the IRS = 126,601,522.
- Potentially all individual taxpayers may experience less burden and easier filing of their tax returns if the IRS ensures taxpayers receive accurate and timely information regarding participation procedures and changes in eligibility requirements.

³ We used \$7.95 as a per tax return *e-file* cost to be conservative. This is the least expensive “for-pay” *e-file* service covering all U.S. Individual Income Tax Returns (i.e., Forms 1040EZ, 1040A, and 1040) among the companies participating in the Free File Program.

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Appendix V

Requirements for Company Participation in the Free File Program

Requirements for Company Participation	
<ul style="list-style-type: none">• Use online tax preparation software approved by the Internal Revenue Service (IRS) that generates tax returns that can be sent to the IRS via an IRS-approved channel.	
<ul style="list-style-type: none">• Be an authorized IRS <i>e-file</i> provider in accordance with IRS Revenue Procedure 2000-31.	
<ul style="list-style-type: none">• Comply with applicable law including, but not limited to, the Department of the Treasury and IRS rules relating to the process of transmitting <i>e-file</i> tax returns to the IRS.	
<ul style="list-style-type: none">• Have a security seal certification program from a third party agreed to by the companies and the IRS. Certification will be based upon an assessment of the system's ability to protect taxpayer data.	
<ul style="list-style-type: none">• Comply with the privacy provisions of 26 U.S.C. § 7216 (2003). Have a privacy seal certification program from a third party agreed to by the participating companies and the IRS.	
<ul style="list-style-type: none">• Agree that provisions of Free Services shall not be conditioned on obtaining an eligible taxpayer's consent to solicitations of additional business.	

Source: Free On-Line Electronic Tax Filing Agreement.

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Appendix VI

Free File Program Eligibility Requirements

Free <i>e-file</i> Offers (Each Row Represents One Company's Free <i>e-file</i> Offer)
Individual taxpayers with Adjusted Gross Income (AGI) ¹ of \$50,000 or more OR who use Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).
Individual taxpayers with AGI of \$33,000 or less.
Individual taxpayers age 50 or older OR whose AGI is \$12,000 or less.
Individual taxpayers with AGI of \$28,000 or less.
All individual taxpayers in active duty military OR whose AGI is \$30,000 or less.
Individual taxpayers with AGI of \$28,000 or less.
Individual taxpayers with AGI of \$30,000 or less.
Individual taxpayers with AGI of \$28,000 or less.
Individual taxpayers with AGI of \$27,000 or less OR who can claim the Earned Income Tax Credit.
Individual taxpayers with AGI of \$28,000 or less.
Individual taxpayers with AGI of \$27,500 or less.
Individual taxpayers with AGI of \$25,000 or less.
Individual taxpayers who live in Illinois, North Carolina, Ohio, or Georgia.
Individual taxpayers who live in Arizona, Georgia, Michigan, or Wisconsin.
Individual taxpayers age 20 or younger.
Individual taxpayers with AGI of \$9,200 or less.
Individual taxpayers with AGI of \$40,000 or less who file a Form 1040EZ with 1 Form W-2.

Source: Internal Revenue Service Free File web page, as of February 11, 2003.

¹ Adjusted gross income equals total income reduced by certain amounts, such as for an Individual Retirement Arrangement or student loan interest.

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Appendix VII

Range of Customer Service Options Offered Under the Free File Program

Customer Service Options (Each Row Represents One Company's Customer Service Options)
Frequently Asked Questions (FAQ) available to answer taxpayer questions.
Customer service is provided completely online, with online FAQ sheets as well as online questions and answers.
FAQ, online searchable database, email, and telephonic assistance (toll call). However, taxpayers will have to search the FAQ or receive email response to be alerted to this option.
Online automated support module. Telephone service only for paying customers.
FAQ. This level of customer service is provided at no charge for all users. For the fee-based users, personalized secure email communication is also allowed for assistance. This or any other level of customer service beyond the automated assistance above will be available to the free filers only if they purchase this option during, or subsequent to, data entry process. Online automated support module is available to all taxpayers. Personal assistance by phone or email will only be available to paying customers.
FAQ. Other customer service options available for a fee.
Step-by-step guided search process. For fee, live chat, or telephonic services are available.
FAQ and email.
FAQ, toll-free assistance, FAX support, email support, and live chat.
FAQ, email, and message center.
FAQ, email, and online manual.
FAQ and online assistance.
Free online self-help center and mail support. Telephone support for a fee.
FAQ and email (24-hour response).
Email and online text chat for a fee.
FAQ and email.

Source: Information provided by the IRS' E-Government Office, based on 16 companies for which this information was available.

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Appendix VIII

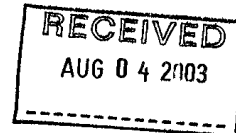
Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

July 31, 2003



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. *[Signature]*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Improvements Are Needed to Ensure That
Individual Taxpayers Have an Easy, No-Cost Option to e-file
Their Tax Returns (Audit #200240083)

As stated in your report, TIGTA's objective was to assess our implementation of the free electronic filing, known as "Free File", initiative for individual tax returns. In general, we agree with your recommendations, which reflect actions we already initiated during the 2003 filing season.

During the 2003 filing season, we received over 2.78 million (as of June 30, 2003) e-filed returns through Free File Alliance members, easily surpassing initial projections of 2.4 million returns. As mentioned in your report, the timeframe to negotiate, develop, and implement the program was extremely short and challenging. Relative to the number of returns, we received very few comments from the public (less than 1 percent of the total number of free returns received) about their Free File experience. Initially set to be available through April 15, all 17 Free File Alliance members extended their free services through October 15, 2003, the end of the e-filing season.

We do not agree that the only performance objective should be ensuring that all individual taxpayers are eligible to use Free File. As you reported, 119 million of the 127 million individual taxpayers were eligible to use Free File this past season, but only 2.78 million taxpayers did so. Therefore, we believe an equally important objective is to increase the program's awareness, which will result in more Free File users. In addition, we acknowledge the coverage of eligible taxpayers may fluctuate from year to year. However, we should not lose sight of our partnership agreement with industry, that the current Administration endorsed, requiring industry to maintain an aggregate eligibility coverage of at least 60 percent of all individual taxpayers.

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to e-file Their Tax Returns

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I have reviewed the outcome measures in your report and do not agree with the methodology and concept that 100 percent of all non-eligible taxpayers will use Free File if given the opportunity. This assumption, coupled with the low probability that 40 percent will not be eligible in the future, yields unreasonable expectations. In addition, we also do not agree that all taxpayers will switch from using tax professionals to using Free File.

In preparation for the 2004 filing season, we are working with the Free File Alliance members to develop program requirements that will improve the overall Free File experience. Some of the suggested enhancements received from taxpayers and interested parties that are being considered include:

- Increasing information about forms and schedules on the Free File web site;
- Improving the customer service options provided by Alliance members; and
- Guaranteeing tax return calculations.

We fully anticipate these suggested changes and our unique partnership with the industry would enable us to deliver an even stronger Free File Program in 2004.

Attached are our comments on your specific recommendations. If you have any questions, please contact Terence H. Lutes, Director, Electronic Tax Administration at (202) 622-7990.

Attachment

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to e-file Their Tax Returns

Attachment

TIGTA Draft Audit Report Improvements Are Needed to Ensure Individual Taxpayers Have an Easy No Cost Option to e-file Their Tax Returns

RECOMMENDATION #1:

To eliminate the costs taxpayers incur to e-file and ensure equitable treatment of taxpayers, the Director, Electronic Tax Administration, should continue to work with industry to maximize the number of individual taxpayers who have the option to e-file at no cost.

CORRECTIVE ACTION:

Although we agree with this recommendation, the terms of the existing agreement are to provide free services to at least 60 percent of taxpayers. We accomplished and exceeded this goal. Even though the agreement does not include a goal to provide free services to all individual taxpayers, we will work with the industry to identify and implement ways to increase the percent of individuals eligible to use these free services.

IMPLEMENTATION DATE:

January 16, 2004

RESPONSIBLE OFFICIAL(S):

Director, Electronic Tax Administration Division

CORRECTIVE ACTION MONITORING PLAN:

We will continue to monitor the coverage of eligible taxpayers and will ensure the measurement exceeds the 60 percent goal of the agreement.

RECOMMENDATION #2:

To reduce taxpayer burden, the Director, Electronic Tax Administration, should ensure taxpayers receive timely and accurate information and should continue to work with industry to eliminate barriers impacting on eligible taxpayers receiving no cost e-filing.

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to *e-file* Their Tax Returns

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CORRECTIVE ACTION:

We agree with this recommendation. As reflected during the 2003 filing season, we were diligent in providing taxpayers with the appropriate information within the Free File web pages to understand, identify, and access free services available to them. Although, we completed the Free File pages using best practices, research shows that web users tend to go directly to areas of interest and generally do not read information designed to provide assistance.

In addition, when we had changes in Alliance member offerings, taxpayers who originally qualified for a free service were given the opportunity to complete their return at no cost (provided they started the return prior to the change). For 2004, we will continue to employ usability practices and work with industry members on improving the way we present and display important information to prospective Free File users.

Furthermore, to ensure the best experience possible and eliminate barriers, we have successfully negotiated with the Free File Alliance to modify their operating agreement. This new agreement will include provisions for the upfront disclosure of supported tax forms and schedules, state programs, and customer service options. These new requirements will help the taxpayer receive accurate and timely information.

IMPLEMENTATION DATE:

January 16, 2004

RESPONSIBLE OFFICIAL(S):

Director, Electronic Tax Administration Division

CORRECTIVE ACTION MONITORING PLAN:

We will continue to use a formal review process to monitor the members' web sites and programs to ensure the agreed-to program requirements set forth in the partnership agreement and the Alliance's operating agreement are met.

RECOMMENDATION #3:

To enable independent monitoring of the Free File Program's success and company compliance with agreement guidelines, the Director, Electronic Tax Administration, should develop a formal process to monitor and measure the success of the program including company compliance with the agreement guidelines.

Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to *e-file* Their Tax Returns

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CORRECTIVE ACTION:

We agree with this recommendation. Shortly after the program's launch in January 2003, we hired a contractor to review the members' web sites and programs. When the vendor, an expert in the online tax software industry, identified concerns they immediately notified the IRS staff and corrective steps were taken.

This year, we successfully negotiated with the Free File Alliance to include a review of each member's offerings prior to service being available to taxpayers. Members will be required to provide the Free File Alliance Director and the IRS with a link to their web sites no less than five business days before the site goes live. All Alliance member sites must be examined and approved before we will post them on our Free File site.

To support this new monitoring activity, we are developing, with contractor support, a procedural handbook that we will use to perform and report on the examination of each web site. Additional monitoring of web sites will occur after the initial review and throughout the filing season to ensure that members make no unauthorized modifications.

We will also develop a set of performance measures. These measures will be developed in cooperation with the Alliance members and will be evaluated against the program's goals and objectives. This will ensure that the program continues to grow and respond to taxpayers needs.

IMPLEMENTATION DATE:

January 16, 2004

RESPONSIBLE OFFICIAL(S):

Director, Electronic Tax Administration Division

CORRECTIVE ACTION MONITORING PLAN:

We will utilize the performance handbook to monitor the performance of each participating web site. In addition, we will track and monitor the program's goals and objectives through the new performance measures.